Economic Update

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Outlook for Investment Markets

Equity prices have had a good start to the year, though the price gains have yet to recover all the ground lost in the global sell-off late last year. The more defensive, income-oriented sectors have done especially well as investors have worried less about the valuation threat from potential bond yield rises, and have viewed less cyclical equities as a useful hedge against global growth shocks. Looking ahead, the central scenario is ongoing global growth at a modestly slower rate, though with significant potential for trade disruptions (US-China, Brexit) and for the policy errors or other accidents that can derail already mature business cycles. Cash and bond yields look likely to remain very low by historical standards. In Australia, recent indicators have been on the weak side, and in particular there is a risk around the impact of falling house prices on household spending, which adds to already cautious consumer behaviour. Assuming the economy manages reasonable though not strong growth, a key issue is whether a middling business outlook can translate into stronger business profits.

Australian Cash & Fixed Interest — Review

The 90-day bank bill yield has dropped a little, and is now 2.0% compared with 2.1% at the start of the year. Long-term interest rates have also drifted a little bit lower, with the 10-year Commonwealth bond yield now 2.15%. The Australian dollar has shown no overall change in trade-weighted value year to date—small gains against the euro, US dollar, and Japanese yen have been counterbalanced by small falls against the Chinese yuan and the British pound.

Australian Cash & Fixed Interest — Outlook

Opinion has shifted on the outlook for short-term interest rates. The Reserve Bank of Australia, or RBA, had been expected to raise rates at some still-distant date, but in recent weeks, more forecasters started to think an eventual rate hike was becoming rather unlikely. In its 8 Feb Monetary Policy Statement, the RBA confirmed a rate hike was no longer inevitable, when it said that it was now neutral about the outlook for rates. In the meantime, market opinion has moved on, and the futures market now expects the outlook is for a cut in the RBA's target for the cash rate, with the futures prices pointing at a 0.25% cut by the end of this year. No joy is expected, in short, for investors hoping for improved returns from cash in the bank.

Local forecasters, like their counterparts overseas, have been winding back the outlook for bond yields as economic growth looks set to be a bit slower than previously expected, and so central banks are consequently less likely to raise interest rates. Last month, for example, Westpac Bank had expected a local 2.7% Commonwealth bond yield by the end of this year; this has been tweaked back to 2.6% in Westpac's latest thinking, which incorporates the US 10-year rate peaking at 3.1% and actually falling through 2020.

On the currency front, the RBA noted there had not been much net movement in the Aussie dollar's value in recent years. The bank reckons the two main drivers of the Australian dollar's value, commodity prices and interest rate differentials had roughly cancelled each other out (commodities up, but differentials widening in favour of overseas). Forecasters are currently a bit more bullish with a Reuters survey of economic forecasters in early February coming up with a picture of appreciation against the US dollar to USD 0.74 in a year's time from the Aussie dollar's current USD 70.9 cents. One major proviso, however, is that a very poor outcome from the US-China talks would likely see the Aussie dollar sold down, partly because periods seen as high risk typically result in investors being less keen to hold currencies like the Aussie, and partly because disruptions to the Chinese economy would be seen as a threat to an important Australian export market.

Australian & International Property — Review

The opening months of this year have generally been kind to the more income-oriented, defensive classes of equity, and the A-REITs have been no exception with a strong start to 2019. Year to date, the A-REITs have outperformed the wider equity market, with a total return of 9.7% compared with the broad market's 7.7%.

Relief from the valuation threat of higher bond yields and increased demand from investors for defensive assets also did wonders for global property. Year to date, the FTSE EPRA/NAREIT Global index is up 10.6% in terms of net return in US dollars, which was even better than the 9.9% net return from the MSCI World index. North American property shares did best among the developed economies, with a 13.4% return. As NAREIT, the US industry group noted, January 2019 was the best month for the US REITs since October 2011.

Australian & International Property — Outlook

The outlook for operating conditions is very diverse across the various subsectors. According to the latest (December quarter) commercial property survey run by National Australia Bank, the best sectors are offices, particularly in Victoria where the respondents expect rents to rise by 3.7% over the next year and property values to appreciate by 2.8%. Industrial is also doing well, with Victoria again the strongest (rents expected to rise 2.9%, values by 2.7%).

But retail is in poor shape, with rents and capital values expected to fall across all states. National Australia Bank pointed to various constraints on consumer spending—"the headwinds of slow income growth, high debt levels and weaker growth in household wealth"—plus there is the ongoing impact of e-commerce on brick-and-mortar outlets. As an example of the retail issues, the share price of Unibail-Rodamco, the owner of the Westfield shopping malls, took a hammering in February when it announced Westfield results had fallen short of expectations. National Australia Bank does not survey residential property development, but other surveys (such as the latest one run by the ANZ Bank and the Property Council of Australia) have unsurprisingly found that it, too, is currently in the doldrums.

Against this mixed business background, the recent outperformance by the A-REITs evidently depended more on investors' defensive mindset than on the fundamentals of the asset class. If investors remain in that frame of mind, the A-REITs could continue to do well, but at some point, a more realistic view of the operating fundamentals is likely to put a damper on sustained performance.

Overseas, the ongoing global expansion has been broadly helpful for property performance. In its latest (December quarter) Global Commercial Property Monitor, the Royal Institution of Chartered Surveyors found "The overarching picture painted by the results ... is one of a generally solid real estate market backdrop despite heightened macro risks across much of the world. Both the RICS Occupier (OSI) and Investor (ISI) Sentiment Indices remain in positive territory for around two thirds of countries included in the Monitor." Country level prospects are diverse. From the investment index of view, a range of continental European markets, and Japan, are currently the pick of the developed property markets, while India and Brazil are the preferred emerging markets.

Goldman Sachs in the latest (December) quarterly update on its international REIT fund said "The resiliency of the asset class [in 2018] was largely driven by stable yields, growth prospects, robust fundamentals, corporate level financial strength, and relatively reasonable valuations." Much of that persists into 2019, although the fundamentals are not quite so supportive, with the further fillip from reduced expectations of bond rate rises. In the current growth-wary environment, global REITs may well remain in favour with investors, though outperformance on the recent scale looks more unlikely.

Australian Equities — Review

Global equity markets have picked up from their late 2018 sell-off, and the global improvement has rubbed off on local shares which have shared in the generally more positive environment. The S&P/ASX 200 Index is up 7.4% in capital value (7.7% including the modest dividends year to date). IT stocks were very strong (up 15.9%) as was the resources sector (up 13.3%), and the A-REITs also did well (up 9.1% and discussed elsewhere in more detail). Despite an "it could have been worse" rally after the release of the Hayne Royal Commission report, the financials lagged the rest of the field, with a more modest 3.9% gain.

Australian Equities — Outlook

The Australian economy has been alternating for some time between periods of acceleration and deceleration, with no definitive move towards consistently faster growth. The most recent readings on the business outlook continue the pattern, and are pointing to a modest deceleration. The latest (January) business survey from National Australia Bank, for example, was an improvement on its weak December predecessor, but otherwise was far from comforting. For example, "Business conditions saw a moderate rebound in January after falling sharply in December … even after this partial reversal, conditions and forward orders continue to trend lower and still show a sizeable decline over the past 6 months. There was no improvement in retail conditions. Confidence edged up but remains below average."

Forecasters and investors consequently are having to have a rethink as, notably, the RBA did in its latest Statement. It wound back its previous GDP forecasts from 3.25% in 2019 and 2020 to 2.75% for both years, which by the standards of macroeconomic forecasting is quite a big move. The outlook for consumer spending in particular is "a key risk." The bank said "the potential for lower household net wealth to affect consumption decisions has increased with recent developments in housing markets."

It was an understated way of pointing out house price falls have been large. On the latest (January) CoreLogic data, national house prices are down 5.9% on a year ago, with larger falls again in Melbourne (down 8.3%) and Sydney (down 9.7%).

It could be that falling house prices have not have broader economy-wide consequences. Westpac, commenting on the latest (February) Westpac/Melbourne Institute Index of Consumer Sentiment, said "the continued house price correction, concentrated in Sydney and Melbourne, is impacting consumer expectations for house prices but so far appears to be having only limited spillover effects on wider confidence." But it still sounds plausible that large shocks to wealth in the biggest cities will have some kind of detectable impact on overall spending—on top of the direct effects on the house building market. While it is only one month's data, the official numbers on December retail sales were below expectations, and consumers appear to be quite cautious about their spending levels.

Even on a reasonably upbeat view of the impact of house prices, however, growth looks like slowing down a bit, and the outlook for corporate profit growth is correspondingly modest. Credit Suisse's latest forecast is for earnings per share growth of 3% this year and of 4% in 2020 for the S&P/ASX 200 companies.

The broad economic backdrop is only moderately helpful for the equity market. Other likely driving factors are a mix. The resources sector will benefit from improving world commodity prices with the latest RBA index of prices showing export commodity in January were up 15.5% on a year earlier in Australian dollars, thanks to higher prices for liquefied natural gas, iron, and alumina. And valuations are reasonable. On Standard & Poor's calculations the forward-looking P/E ratio is 15.4 times expected earnings. On the downside, though, it is not clear whether the large financial sector has stopped being a drag on performance. Five of the top 10 biggest stocks in the S&P/ASX 200 index are banks, and although the heavyweight sector has already discounted a lot of bad news (the prospective P/E ratio for the financials is down to 11.9) there may be more poor performance to come. And Australian equities are among the more exposed to any setback to the Chinese economy if the current US-China trade tensions intensify.

Overall, Australian shares in the near term look likely to continue to participate in the global recovery from last year's sell-off. Further down the track, the outlook is more mixed, and barring a helpful resolution of international trade issues, it is not yet obvious what might be the base for ongoing strong equity performance.

International Fixed Interest — Review

There has been very little net movement in government bond yields year to date, with bond yields slightly lower in the US, the eurozone, Japan, and the UK. The result is that the returns from holding government bonds are close to the (low) running yields, with little or no changes in capital values. The Bloomberg Barclays Global Aggregate index of government bonds in US dollars has returned 0.3% to date.

Returns from corporate debt, particularly low-quality "high yield" debt, and from emerging markets debt have been rather better with the respective Bloomberg Barclays US dollar indexes having returned 2.0%, 4.7%, and 3.5%. What looks like strong performance, however, should be better viewed as a clawback of the losses of late 2018. As investors had worried about the outlook for the global economy, credit spreads for corporates blew out leading to capital losses, and emerging market bonds had also fallen out of favour. Overall, combining the low return on government bonds and the higher returns from nongovernment debt, the Bloomberg Barclays Global Aggregate has returned 0.7% year to date.

International Fixed Interest — Outlook

Central banks everywhere have found themselves in the same position. They had originally planned on gradually normalising interest rates, in a world where economic growth was good and inflation was rising back to where the central banks had wanted to see it. Now, however, the outlook for global growth—while not outright poor—looks less assured, and central banks are having, at a minimum, to put their plans on hold and, if growth were to turn weaker again, having to contemplate reversing course back towards even lower rates than today's.

The key player has been the Fed. It decided at its 30 Jan policy meeting not to raise interest rates any further, and to leave the target range for the federal-funds rate at 2.25% to 2.50%. It also said it would be "patient as it determines what future adjustments to the target range for the federal-funds rate may be appropriate." The financial markets currently take "patient" to mean that rate rises are now off the agenda for the rest of this year. The Chicago Mercantile Exchange's FedWatch tool, based on futures prices, is showing an 85% chance of no change in interest rates this year and a slightly higher probability (11%) of a 0.25% cut than for a 0.25% increase (only 3% chance).

The same rethink is going on in the eurozone, where the European Central Bank had taken one step towards more normal monetary policy (it stopped buying more bonds at the end of December). But that is as far as it is likely to go, given the economic indicators showing a slowing eurozone economy. The bank has said it "expects the key ECB interest rates to remain at their present levels at least through the summer of 2019," but forecasters believe any increase will be in 2020 at the earliest, and the bank may even have to find some weapon in its armoury to provide more help to the eurozone.

For fixed interest investors, what had looked like the prime threat—bond yields marching back up from their unusually low post-GFC levels—looks off the table for the time being. Early last year, for example, the US economists polled by *The Wall Street Journal* were expecting a 10-year bond yield in the US of 3.5% by the end of this year; now they expect 3.0%. The good news on less risk to bond capital values is balanced, however, by the prospect of an even longer period of very low running yields (the yield on the 10-year government bond in Switzerland is now back down to negative 0.29%, and is also marginally negative in Japan).

The other factor in play is the combo of potential global slowdown and the US-China trade tensions. If the slowdown is not as much as expected, or there is a happy outcome on the trade front, bonds will not thrive. But if there are poorer outcomes, then bonds will replay their capital-preserving role through the equity market volatility of last year. Investors may well feel a degree of insurance cover looks a better option than guessing at geopolitics.

International Equities — Review

World share prices have been rising year to date, with the MSCI World index of developed economy shares now up 9.9% (in terms of the overseas economies' own currencies) and by 9.7% in US dollar terms. The large rise, while welcome, has not yet been quite enough to make back all the ground lost in the final quarter of 2018: in US dollar terms, the index is still 6.5% below its recent pre-sell-off peak on 21 Sept, and 8.8% below its all-time high back in January 2018.

The gains have been widely spread. In the US, the S&P500 Index is up 9.9% and the tech-heavy NASDAQ Composite index is up 12.6%. European shares, despite a weakening economic backdrop, have also done well, with the FTSE Eurofirst300 index up 9.1% in euros. Even in the otherwise Brexit-raddled UK market, the FTSE100 index is up 7.6% in British pounds. Gains were more modest in Japan, where the Nikkei is up 4.4% in Japanese yen.

Emerging markets have also seen year to date gains, though the 6.7% US dollar rise for the MSCI Emerging Markets index is quite modest set against the brutal 16.6% loss for the sector in 2018. The core BRIC markets (Brazil, Russia, India, China) are up 8.5% in US dollars. Three of the four delivered sizable gains, but the overall result was held back by the weak Indian sharemarket, where a marginal (down 0.7%) fall in rupee terms for the Sensex index was aggravated by a 2.5% decline of the rupee against the US dollar.

International Equities — Outlook

It would be nice to be able to say the interlinked worries that triggered the big sell-off in equities late last year had all been resolved, but sadly, the outlook remains up in the air for some of the key moving parts. The outlook for the global economy, for some of its key players, and for the outcome of the various threats to world trade (US-China and Brexit, in particular) are all still in play.

On the upside, the potential threat from monetary policy mistakenly being tightened too much now looks much less of an issue, and share valuations being too expensive, particularly in the US, are also less troubling. Higher US corporate profits and lower equity prices have brought the prospective P/E ratio on the S&P500 down to a more reasonable 15.8 times expected earnings (on data company FactSet's estimate). They have been helpful developments, but other large uncertainties remain.

On the global business cycle, the likelihood is the world economy will continue to "muddle through" at a slightly slower rate of growth than previously. That is still the central view of both the IMF and the World Bank, but everyone agrees the risks are loaded to the downside. The latest (January) JP Morgan Global Composite purchasing managers' indices, or PMIs, found "global economic growth slowed to a 28-month low, as inflows of new work rose at a weaker pace and international trade in goods and services fell for the second month in a row," suggesting the downside may be getting some traction.

By country, it is a mixed bag. The US has been doing well with likely growth of 3.0% last year. But on the consensus view of the economists polled by *The Wall Street Journal*, it will slow to 2.2% growth this year, and further again to a distinctly indifferent 1.7% rate of growth in 2020, with the rundown of fiscal stimulus (the Trump tax cuts) being a key factor. Arguably, the slowdown could be appearing earlier than expected with some of the most recent indicators very strong, notably the very big rise in employment in January, but others have been outright poor, for example, December retail sales, January industrial production. It is likely 2019's equity markets will be prone to volatility off the back of changes in investors' assessment of the US cyclical outlook.

Another key factor influencing sentiment is corporate profits in the US, given that for much of 2018 global equity investment outcomes were heavily dependent on ongoing strong profit generation by American companies. The good news is 2018 turned out to be a good year. At time of writing, some two thirds of US corporates had reported their 2018 results, and for the S&P500 companies, profits were some 20% up on 2017, according to data company FactSet's estimates.

But the less comforting news was the profit gusher looked to be weakening rapidly with profits in the final quarter of 2018 running only 7% ahead of a year earlier, and the forecasts collated by FactSet currently show S&P500 profits are expected to grow by only 5% this year, and most of that is expected, perhaps optimistically, to happen later in the year. Profits are expected to show little or no growth in the first three quarters, but turn in a boomer final quarter.

Outside the US, there is also mixed news. On the plus side, Japan's economy bounced back in the December quarter from a natural disaster-affected September, and according to officials at the Bank of Japan, the Japanese economy will grow by 0.9% in the current March-end year, and by similar modest rates in the coming two years (0.9% to March 2020, 1.0% to March 2021). And although analysts agonise over the Chinese "slowdown" after a year when its economy grew by "only" 6.6%, the reality is economic policy will be used to keep China growing at close to 6% growth rates (fiscal and monetary policy have already been deployed to give the economy a lift). On the downside, however, there have been some very soggy official and private sector data out of the eurozone with, for example, the latest IHS Markit Composite PMI showing that "The eurozone has started 2019 on a flat note, with growth close to stagnation amid falling demand for goods and services," and Brexit has the potential to further disrupt both the UK and UK-European trade.

There are, in sum, a variety of economic cross-currents which hopefully will resolve into ongoing, if slower, growth in global business activity, which would be supportive of further equity market recovery. But the reality is what would be a fair-to-middling business outlook is still hostage to a major imponderable: the political threat to global trade and supply chains from trade. Markets in recent weeks have been vacillating from optimism to pessimism about the US-China trade negotiations in particular, but nobody has a clear idea of what the endgame will be.

For many investors, the best approach will combine diversification across asset classes, for example, downside insurance via bonds, and placing some emphasis within equities on less cyclically-exposed sectors. The long post-GFC investment cycle has survived a series of shocks that seemed highly troubling at the time, and these latest trade tensions may also pass without lasting damage. But when inept and intransigent politicians have taken the helm, it will likely pay to be prepared for trade policy mistakes.

Performance periods unless otherwise stated generally refer to periods ended 15 Feb 2019.

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